M E M O R A N D U M

July 31, 2001

TO: Mike Naeve

FROM: Kathryn Kavanagh Baran

RE: Liability Limiting Provisions in Transmission Tariffs and Related Agreements

This memo surveys the history, significance, and validity of provisions which limit the liability of public utilities. Applicants seeking to form Regional Transmission Organizations ("RTO"), and transmission providers in general, have expressed concern that, given the current policy of the Federal Energy Regulatory Commission ("FERC" or "Commission"), they could face exposure to massive damages resulting from unintended interruptions in service. This memo is organized as follows:

1. Introduction

The massive restructuring and regulatory adjustments which have taken place in the electrical energy industry in recent years inadvertently may have opened the door to transmission companies being held liable for massive damages stemming from power outages. If a transmission company fails to identify and trim a rotten tree limb along its vast network of transmission wires, and the fallen limb results in a service interruption, it is conceivable that the transmission company could be liable for consequential damages or economic losses incurred by its generating customers who could no longer move power to its destination. In the same vein, third-parties who have experienced harm as a result of not receiving power as a result of the accident could conceivably successfully claim damages against the transmission company.

This memo (a) surveys the history of public utility liability limitations, (b) explains the Commission's current policy of rejecting such provisions, and (c) discusses how that policy comports with analogous state and federal laws. The memo concludes that, in order to create favorable conditions for financial risk-taking in the ownership of transmission facilities and to promote the formation of regional transmission operations, the Commission should permit parties to limit their exposure to consequential damages, third-party claims, and claims for damages related to simple negligence or "normal accidents."[1]

2. Potential Liabilities for Utilities Resulting from Interruption of Service

Civil liability for public utilities that fail to meet their obligation to serve customers "is neither tortuous nor contractual but is rather sui generis." Prosser & Keeton, § 92 The Law of Torts 663 (5th Ed. 1984) (hereinafter "Prosser & Keeton"). Under conventional contract law, a party that falls short of fulfilling its bargained-for promise may be held liable for damages, no matter what the underlying reason for the breach. See Globe Ref. Co. v. Landa Cotton Oil Co., 190 U.S. 540, 544 (1903) (Holmes, J.). However, because the common law obligates utilities to "serve all comers," services provided by public utilities are one of the "few situations in which failure to perform a contract may amount to a tort." Prosser & Keeton at 662.[2]

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[1] Transmission of electrical energy can be considered to be a "high risk, high reliability" undertaking where "the risks of the enterprise have catastrophic potential and are characterized by high risk technologies, where no matter how effective conventional safety devices are, there is a form of accident that is inevitable." See Barbara A. Cherry, The Crisis in Telecommunications Carrier Liability: Historical Regulatory Flaws and Recommended Reform (Kluwer Academic Publishers 1999) at p. 61 (internal quotation omitted) (describing high risk, high reliability enterprises as prone to "normal accidents").

[2] For a detailed and interesting description of the evolution of this dual liability exposure facing public utilities, see Cherry, supra at pp. 48-57 (explaining that the tort prong of the liability stems from a duty owed by common carriers to serve and to insure the property entrusted to them and that the contract prong of the liability stems from the later-developed public utility law relating to

In some public utility cases, the failure to perform involves "a breach of a duty that may reasonably be regarded either as assumed by contract or as one imposed by the law independently of contract." 4 Corbin on Contracts § 1077 at 443 (1951). "In such cases, if the plaintiff so desires, the action may be treated as for tort, and the damages will be assessed according to the rules applicable in tort cases, sometimes including punitive damages." Id. Therefore, liability for a transmission company may be analyzed under either principles of contract, tort, or some combination of both.[3]

a. Contract Liability

If an action lies in contract, a defendant may be held liable for breach only if (a) there is privity of contract between the plaintiff and the defendant, or (b) if plaintiff was an intended third party beneficiary of a contract. See Beck v. FMC Corp. 385 N.Y.S.2d 956, aff'd 398 N.Y.S.2d 1011 (1976) (holding that employees suing for wages lost during service interruption were merely incidental beneficiaries of the contract and, although they benefited from the performance of the contract, the electric company owned them no independent duty for the loss of the benefit). The right of a third party beneficiary is derived when the contract itself has created reasonable expectations and will induce the third party to change its position in reliance. See 4 Corbin on Contracts § 775. However, the common law of third-party beneficiaries varies from state to state. See American Electric Power Co. v. Westinghouse Electric Corp., 418 F.Supp. 435, 447-49 (1976) (comparing Pennsylvania law where third party beneficiaries must be indicated in the contract and New York law where intent to confer a benefit need not affirmatively appear within the four corners of the agreement).

If a breach of contract exists, "compensatory damages will be given for the net amount of the losses caused and gains prevented . . . ." 4 Corbin on Contracts § 992 at 6 (quoting Restatement, Contracts § 329). As a rule, consequential damages will be denied, unless they "may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract as the probable result of the breach of it." Hadley v. Baxendale 156 Eng. Rep. 145, 151 (1854). However, to be liable, the party in breach need only have been given notice

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governmentally-granted franchises to conduct business which was in the "public interest." Thus, a number of entities – railroads, telephone companies, e.g., – are considered to be both common carriers and public utilities.).

[3] Although public utilities are required to serve the public, they are generally not required to guarantee uninterrupted service. See, e.g., In re Ill. Bell Switching, 161 Ill.2d 233, 243 (1994) (stating that utility is only required to provide adequate efficient, reliable and environmentally safe and least-cost service).

of facts that made it foreseeable that the loss would result in such damages. Farnsworth on Contracts § 12.14. The magnitude of the loss need not have been foreseeable. Id. In the case of a power outage, compensatory damages – for example, lost generator sales revenues – can be extraordinary and potentially debilitating.[4]

Thus, under principles of contract law, in the event of a service interruption, the transmission company may be liable for breach of contract to those customers with whom it is directly in privity as well as those with whom – given the common law of the state – are third party beneficiaries. The measure of damages would depend, in part, on the plaintiff's ability to prove that the extent of its loss was foreseeable by the transmission provider.

b. Tort Liability

In tort, however, a defendant can be held liable for negligent conduct if the court finds that the defendant owed a duty of care to the plaintiff. Prosser and Keeton § 30 at 164. The extent of a plaintiff's duty is recognized by law, id., and it is the responsibility of the courts to fix the orbit of duty "to limit the consequences of wrongs to a controllable degree." See, e.g., Strauss v. Belle Realty Co., 65 N.Y.2d 399, 402 (1985) (circumscribing the scope of duty to protect against "crushing exposure to liability" and stating that "in determining the liability of utilities for damages for failure to provide service . . . courts have declined to extend the duty of care to noncustomers") (emphasis added). See also, Kentucky Agricultural Energy Corp. v. Bowling Green Municipal Utilities Bd., 735 F. Supp. 226, 230-31 (1989) (applying Kentucky law and finding no duty ran from wholesaler of electric power (Tennessee Valley Authority) to once-removed purchaser).

The importance of limiting the scope of potential liability for public utilities is well established. "[T]he imposition of tort liability on those who must render continuous service . . . to all who apply for it under all kinds of circumstances could be ruinous and the expense of litigating and settling claims over the issue of whether or not there was negligence could be a greater burden to the rate payer than can be socially justified." Prosser and Keeton, § 93, at 671.

Thus, under principles of tort, in the event of a service interruption, the transmission provider may be liable for damages to those customers to whom it

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4 The Electric Power Research Institute recently reported that power outages and other power quality disturbances cost the U.S. economy more than $119 billion annually. See Electric Power Research Institute, The Cost of Power Disturbances to Industrial & Digital Economy Companies, Press Release, July 16, 2001. <http://ceids.epri.com>.

has a proven duty of care. As a general policy, courts do not extend this duty to those who are not direct customers. See generally, Liability of Electric Utility to Nonpatron for Interruption or Failure of Power, 54 ALR4th 667 (1987).

3. Liability Limiting Provisions

In general, the law permits a party to exempt itself from liability or to limit its liability in tort for harm it caused by negligence, as long as the provision is not unconscionable. Farnsworth on Contracts § 5.2. However, the original rule was that "a common carrier or a public utility cannot exempt itself from liability in negligence to one it has contracted to serve in that capacity, although it may be allowed to limit its liability to a reasonable agreed value in return for a lower rate." Id. Thus, today, most liability limiting provisions which are included in tariffs are justified as resulting in a lower rate for the customer.[5] This aspect of public utility liability is discussed later in this section.

Courts and agencies have espoused a variety of justifications for limiting the liability of a public utility. These theories include the aforementioned benefit to customers of the lower and uniform rate, principles of estoppel, the filed rate doctrine, the regulatory contract theory (that in exchange for regulatory oversight a utility may be permitted to limit its liability), and technical considerations. See Barbara A. Cherry, The Crisis in Telecommunications Carrier Liability: Historical Regulatory Flaws and Recommended Reform (Kluwer Academic Publishers 1999) (hereinafter "Carrier Liability") at 29. It is typical to see several justifications interwoven throughout a specific opinion addressing the issue. See, e.g., Western Union Telegraph Co. v. Esteve Bros. & Co., 256 U.S. 566 (1921).

A seminal case held that although a public utility may limit its liability, it may not wholly exculpate itself from liability for damages caused by its own negligence. See Primrose v. Western Union Telegraph Co., 154 U.S. 1, 15 (1894) (citing cases). Cf. Bisso v. Inland Waterways Corp., 349 U.S. 85 (1955) (invalidating as contrary to public policy contracts which released tug-towers from all liability for their negligence). This stance was subsequently modified in Southwestern Sugar & Molasses Co. v. River Terminals Corp., 360 U.S. 411 (1959), which held that "[t]he rule of Bisso, however applicable where the towboat owner

[5] Note, however, that the liability limiting provisions addressed in the case of United Gas Pipeline Co. v. FERC, 824 F.2d 417 (5th Cir. 1987), see infra text accompanying note 9, were not justified as resulting in a lower rate for the customer, but instead upheld as necessary to protect the federal interest of the federally mandated curtailment plans. This is one way in which United Gas is poor precedent for the Commission's refusal to consider the inclusion of liability limitation in the pro forma tariff or other transmission tariffs.

has the power to drive hard bargains,' may well call for modification when that power is effectively controlled by a pervasive regulatory scheme." Southwestern Sugar, 360 U.S. at 418. An exculpating clause could be permitted if the regulatory body determined that the tariff reflected the cost-savings that would result from the service providers not needing to insure against potentially unquantifiable losses resulting from simple negligence. Id. at 420. Therefore, the liability limitation was justifiable if it was tied to the rate.

It is now considered axiomatic that the rates charged by a utility "should be directly related to the nature and extent of liability imposed for interruption of service . . . . The consequential damages from a [negligently caused] blackout . . . can be enormous and most regulatory agencies take this into account in establishing limitations on liability." Prosser & Keeton at 663; see also, Siren, Inc. v. Estes Express Lines, ___ F.3d ___ (2001 WL 435610 *5) (11th Cir. (Fla.)) (citing Hart v. Penn. R. Co., 112 U.S. 331 (1884) (asserting that the rate charged is bound up with the valuation of the shipment)).

This rule is grounded in principles of estoppel. The shipper may not repudiate the conditions under which it obtained the lower rate. That is, it may not sue for more than the agreed-upon limited amount, even if the loss stemmed from the carrier's negligence. Prosser & Keeton at 663. Once a tariff has been filed, a limitation of liability which attaches to a certain rate is binding unless and until it is set aside as unreasonable by the jurisdictional regulatory commission. See Western Union Telegraph Co. v. Esteve Bros. & Co., 256 U.S. 566, 572 (1921). "The limitation of liability [is] an inherent part of the rate." Id. at 571.

In keeping with the reasoning that liability limits are interwoven into rate determinations, the century-old "filed rate doctrine" teaches that "the rate [and terms] of the carrier duly filed is the only lawful charge." See American Tel. & Tel. Co. v. Central Office Tel., Inc., 524 U.S. 214, 222 (1998) (quoting Louisville & Nashville R. Co. v. Maxwell, 237 U.S. 94, 97 (1915)). Therefore, a liability limiting clause in a tariff filed with, and subject to the pervasive authority of, an expert administrative body will be upheld as a matter of law. See Southwestern Sugar, 360 U.S. at 421 (determining that the Interstate Commerce Commission was the proper forum for resolving whether "the particular circumstances of the . . . industry . . . [would] lend justification to this form of clause"). The courts substantially defer to an agency's approval of a limitation of liability clause, as they consider the tariff to define the legal duty of the utility. See Rendi L. Mann-Stadt, Limitation of Liability for Interruption of Service for Regulated Telephone Companies: An Outmoded Protection?, 1993 U. Ill. L. Rev 629, 638 (citing Southwestern Sugar).

Under these precedents and policies, liability limiting language included in a transmission company's tariff and agreements should be given effect if the company can demonstrate that the rates in its tariff are based upon the financial benefits to the rate payer derived from either (a) an exculpation from liability for acts of simple negligence, and/or (b) limitations of liability for consequential damages, and/or (c) liability boundaries which do not extend to include third parties.

4. The Federal Energy Regulatory Commission Rejects Liability Limitations between Customers and Transmission Providers

a. The Current Policy

The Commission consistently disapproves any clauses included in transmission tariffs or agreements that would limit the scope of a transmission provider's exposure to consequential or other third-party damages. [6] Apparently,

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[6] See, e.g., Avista Corp., et al., 96 FERC ¶ 61,058 (2001), Slip Op. at 21-22 (permitting RTO West transmission owners to allocate risk among themselves and the RTO but rejecting any allocation of risk between transmission providers and customers related to third-party claims); Cambridge Electric Light Co., et al. ("NSTAR"), 95 FERC ¶ 61,339 (2001), Slip Op. at 12 (requiring NSTAR to delete the provision limiting liability from its standardized Interconnection Agreement); Avista Corp., 95 FERC ¶ 61,114 (2001), Slip Op. at 52 (rejecting liability limitation agreement proposed to be executed among all RTO West participants); GridFlorida, LLC, 94 FERC ¶ 61,363 (2001), Slip Op. at 24 (rejecting proposal to incorporate liability provisions into the Participating Owners Management Agreement); Arizona Public Service Co., 94 FERC ¶ 61,027 at 61,082 (2001) (rejecting alternative liability and indemnification language in Interconnection Agreement because "the indemnification provision of the pro forma tariff is not a provision for which we allow deviations based on regional practices or company-specific arrangements"); New York Indep. System Operator, Inc., et al., 90 FERC ¶ 61,012 at 61,034-35 (2000) (rejecting language limiting liability except in circumstances of negligence or willful misconduct because the pro forma tariff was not intended to address liability issues); on reh'g 91 FERC ¶ 61,012 at 61,051 (2000) (agreeing that liability insurance is a cost of doing business and a recoverable cost of service); Consolidated Edison Co. of New York, Inc., 84 FERC ¶ 61,163 (1998) (rejecting additional liability limitation provision in the retail service agreement which is part of the pro forma tariff); Delmarva Power & Light Company, 88 FERC ¶ 61,247 (1999) (rejecting both parties' efforts to address liability issues under the Interconnection Agreement); New York Power Authority, 82 FERC ¶ 61,078 (1998) (finding NYPA has improperly limited its liability to cases of gross negligence or willful misconduct); Niagara Mohawk Power Corp., 81 FERC ¶ 61,180 (1997) (directing elimination of provisions in transmission service agreement which would add language related to liability); Pacific Gas and Electric Co., et al., 81 FERC ¶ 61,122 at 61,520 (1997) (finding overbroad proposed limitations on liability in that "it is appropriate for the ISO or PX to be protected from liability that may occur when

this is a relatively new policy. See Transmission Access Policy Study Group, 255 F.3d 667, 727 (D.C. Cir. 2000) (hereinafter "Transmission Access") ("In the past, FERC . . . allowed electric utility tariffs to explicitly limit a utility's liability for service interruptions to instances of gross negligence or willful misconduct.").

When issuing the pro forma Open Access Transmission Tariff of Order No. 888,[7] the Commission initially included no liability limiting provisions, except those relating to indemnification. See Transmission Access at 727. Section 10.2 of the pro forma tariff established the policy that negligent acts or omissions on the part of the transmission provider would not be eligible for indemnification. See id. (citing Order No. 888, at 31,936-37).

Throughout the rulemaking process related to establishing the Commission's new Open Access policy, many participants argued that (a) the Commission should permit indemnification to extend to damages resulting from negligent acts and, (b) that liability limiting language should be included in transmission tariffs and related agreements. See Order 888-B at 62,081. To those arguments, the Commission responded that liability and indemnification were "separate issue[s]" and that transmission providers seeking liability protections could rely on state laws. See Order No. 888-A at 30,301. Ultimately, the Commission refused to permit inclusion of what it considered to be any "exculpatory language in the tariff that would protect the transmission provider from liability" caused by simple negligence. See Order No. 888-B at 62,080. Since establishing this policy, the Commission repeatedly has directed parties to remove specific liability limiting provisions in transmission tariffs or their related agreements. Applicants to form RTO West recently experienced the effects of this Policy. See Avista Corp., 95 FERC ¶ 61,058 (2001), Slip Op. at 52.

Therefore, given that the Commission disfavors liability limitations in general, the transmission company's tariffs and agreements – which include liability limiting language – may not protect the company under certain scenarios.[8]

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the ISO or PX is not negligent in the performance of its responsibilities under its Tariff") (emphasis added).

7 See Promoting Wholesale Competition Through Wholesale Open Access Non-Discriminatory Transmission Services by Public Utilities, Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, FERC Stats. & Regs. p 31,036 (1996) (Order No. 888), order on reh'g, FERC Stats. & Regs. ¶ 31,048), (1997) (Order No. 888-A), order on reh'g, 81 FERC ¶ 61,248 (1997) (Order No. 888-B), order on reh'g, 82 FERC ¶ 61,046 (1998) (Order No. 888-C).

8 A number of permutations of agreements, tariffs, and liability limiting language can be anticipated:

b. An Unsound Basis for the Policy

The Commission initially supported its position for the Final Rule – that the transmission customer need not indemnify the transmission provider "in cases of negligence" – by citing Pacific Interstate Offshore Company, 62 FERC ¶ 61,260, at 62,733 (1993). See Order No. 888 at 31,765. Pacific Interstate held that a natural gas pipeline should not be protected for damages arising out of acts of simple negligence. That case, like many of the cases addressing this issue in the gas industry, is traceable to the decision in United Gas Pipeline Co. v. FERC, 824 F.2d

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(a) For example, if the transmission company is providing service to a generator through an Interconnection Agreement ("IA"), three scenarios present themselves. First, if the generator is also a signatory to the transmission company's pro forma contract (with liability limiting language) then the transmission company's liability might be limited. Second, if the generator is operating under a pre-existing contract (without liability limiting language), then the transmission company's liability would not be limited. Third, if the generator is a new customer, and not a signatory of the transmission company's pro forma contract, it could protest the liability limiting language and, given the Commission's policy, likely succeed in obtaining a Commission order to eliminate the language. In that case, the transmission company's liability exposure would not be limited.

(b) Furthermore, the transmission company would face liability exposure in cases where it executes a transmission contract with generators under the pro forma tariff (which does not include liability limitations). It is unclear whether the pro forma tariff (without liability limitations) would trump an interconnection agreement operating with the transmission company's pro-forma contract (with liability limitations). Although, if the interconnection contract is a schedule to the transmission tariff, it would be considered to be part of the tariff.

(c) On the other hand, if the end-user or marketer is a transmission customer (who is not a generator or distributor), the language of the specific Interconnection Agreement will determine whether liability limitations apply. (This assumes that there is an Interconnection Agreement. For example, a marketer could be the transmission customer, but have no Interconnection Agreement because it has no physical transmission facilities.) The aggrieved party could sue the transmission company under a separate Transmission Contract for failure to deliver. Liability limitations included in interconnection agreements between the transmission provider and the generator or the ultimate purchaser could be irrelevant as privity would be between the transmission provider and its transmission customer.

(d) Finally, liability limiting issues related to distribution companies can be analyzed in the same manner as generators (see (a) above).

417 (5th Cir. 1987).[9] On this tiny grain of a foundation, the Commission has erected an impenetrable barricade to limitations on liability proffered by transmission providers.

In United Gas, the circuit court rejected arguments that the Commission (a) should have articulated a uniform federal standard of culpability, (b) should have allowed damages only when a customer proves that the transporter acted in bad faith or with willful misconduct, and (c) if a negligence standard were to be adopted, that the Commission itself should adjudicate the claims. See id. at 426.

Given the significant precedent established by United Gas, it is important to recognize that the holding is unrelated to permitting tariffs to include exculpation clauses for negligence, third party claims, and/or limitations on consequential damages.

The Commission's ruling in United Gas concerned a liability provision that not only exculpated the pipeline company for simple negligence but also for "willful misconduct" related to failure to honor its commitments. 20 FERC ¶ 63,070 at 65,304 (1982). The Commission did not address the reasonableness of the provision, but rather upheld, without discussion the findings of an administrative law judge.[10] See United Gas, 31 FERC ¶ 61,336 (1985). The ALJ had rejected the liability clause for essentially four reasons:

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[9] The other gas cases rejecting such clauses on the basis of the United Gas decision include: Arkla Energy Resources Co., 64 FERC ¶ 61,166, at 62,490 (1993); National Fuel Gas Supply Corp., 63 FERC ¶ 61,291, at 63,021 (1993); National Fuel Gas Supply Corp., 64 FERC ¶ 61,276, at 62,951 (1993); Alabama-Tennessee Natural Gas Co., 49 FERC ¶ 61,127, at 61,540-41 (1989); Sea Robin Pipeline Co., 46 FERC ¶ 61,061, at 61,284-85 (1989) (citing Bisso); Kentucky West Virginia Gas Co., 45 FERC ¶ 61,134, at 61,397 (1988); Texas Eastern Transmission Corp., 44 FERC ¶ 61,413, at 62,325 (1988).

[10] The ALJ determined that United should not be absolved of liability for its own negligence. 20 FERC ¶ 63,070, at 65,304 (1982). United did not contest this determination on exceptions to the Commission, nor did any other party. Opinion 237, 31 FERC at 61,769 ("United does not take exception to the rejection of its proposed version of section 12.3 and to the adoption . . . of the section modified to exclude liability except if resulting from negligence or willful misconduct"). Nevertheless, on rehearing, United raised the matter indirectly, arguing that the FERC should have specified a "uniform Federal standard of bad faith rather than common law negligence [to] be applicable [in] curtailment damage suits." Opinion 237-A, 35 FERC ¶ 61,344, at 61,787 (1986). The Commission, in its rehearing order, rejected the argument without discussion. Id. at 61,788. United later raised this argument in its petition for review. The court of appeals affirmed

> [1] Actions grounded in negligence are not exculpable by contract or stipulation. A common carrier may not exculpate itself from liability for negligence. Bisso v. Inland Waterways Corp., 349 U.S. 85 (1955) . . . . [2] The Commission has refused to approve a provision in a pipeline tariff designed to hold a pipeline harmless where it was at fault. Tennessee Gas Pipeline Company, 57 FPC 1593, 1603-04 (1977). [3] The Courts of Appeals in Monsanto Co. v. FPC, 463 F.2d 799 (D.C. Cir. 1972) and International Paper Co., supra, have said that if the pipeline created the shortage, it could be liable in damages despite a lawful Commission curtailment order. [4] It would undermine all incentive for prudent management if a pipeline could willfully overextend itself, confident that it need not honor its commitments as long as it allocates any shortages it brings upon itself in conformity with a curtailment plan approved by the Commission.

20 FERC at 65,304 (brackets added).

None of these bases for a decision support the finding that a pipeline (or any other utility) should, contrary to the prevailing rule, be liable for damages caused by its simple negligence. See infra sections 5 and 6. Each element of the judge's decision is discussed here in the footnotes.[11] Most notably, however, the

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the Commission for the same reasons as contained in the ALJ's order. See 824 F.2d at 427.

[11] First, the judge's finding that "[a]ctions grounded in negligence are not exculpable by contract or stipulation" is not correct. Actions grounded in negligence are exculpable, especially in utility tariffs. See Southwestern Sugar, 360 U.S. at 417. The judge's citation to Bisso was inapposite: the Supreme Court held in Southwestern Sugar that Bisso does not apply where the limited liability provision is contained in a tariff "filed with, and subject to the pervasive regulatory authority of, an expert administrative body." 360 U.S. at 417.

Second, the citation to Tennessee Gas Pipeline Co., 57 FPC 1593 (1977) is not helpful, since there the Commission simply stated that "[c]learly a pipeline cannot use its curtailment plan or the language of a curtailment plan, by itself, to avoid contract liability no matter what is the cause of the gas shortage." Id. at 1603-04 (emphasis added). Tennessee Gas thus did not address the simple negligence issue either directly or indirectly.

Third, the citations to Monsanto Co. v. FPC, 463 F.2d 799 (D.C. Cir. 1972) and International Paper Co. v. FPC, 476 F.2d 121, 131 (5th Cir. 1973) (Brown, J., Commission's analysis did not segregate liability limitations related to simple negligence from those related to willful misconduct. See 20 FERC at 65,304 ("It would undermine all incentive for prudent management if a pipeline could willfully overextend itself, confident that it need not honor its commitments as long as it allocates any shortages it brings upon itself in conformity with a curtailment plan approved by the Commission.") (emphasis added).

As a rule, in pipeline cases, the Commission has permitted tariffs to include exculpatory language addressing breach of contract claims that the transporter may face as a result of service interruptions caused by system-required curtailments. See, e.g., Transcontinental Gas Pipe Line Corp., 35 FERC ¶ 61,043 (1986) (stating claims resulting from curtailments are preempted by Federal law). However, if the curtailment itself, or some other interruption, is caused by negligence or willful misconduct, the transporter may be held liable for damages flowing from its role in creating the curtailment or interruption. See United Gas, 824 F.2d 417 (1987).

The policy implications of the Commission's decision are enormous. The significance of the United Gas holding is that an erroneous decision, made by an administrative law judge, where distinct issues were compounded (simple negligence and willful misconduct) has resulted in setting policy for an entire industry – an industry very different from the one at issue in the original pipeline decision.

In the electric industry, unlike the gas industry, each utility is integrated with every other utility in its grid (i.e., the Eastern, Western and ERCOT grids), so that an outage on one system can cause an outage on many other systems. In the natural gas industry, by contrast, most pipeline systems are not interdependent on the operation of other systems. In addition, electric systems are much more vulnerable to wind, rain and ice storms than are natural gas pipelines. Moreover, electricity, unlike gas, cannot be stored. Thus, a utility cannot simply retrieve stored reserves in the event of an emergency. All of these factors suggest that the scope of liability from interruptions of service is much greater in the electric industry – with potential liability to millions of customers who could bring thousands of claims.

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concurring) are also inapposite, since the Monsanto court stated "we do not decide [the] question, but only identify the problem" of determining when a pipeline should be held liable for curtailing its customers, 463 F.2d at 808, and Judge Brown's concurring opinion in International Paper suggested only that a pipeline "might" be liable for a "bad faith" curtailment of its customers. 476 F.2d at 131 (emphasis in original). Again, the simple negligence issue was not addressed.

Thus, transmission providers are potentially exposed to tremendous liabilities as a result of a poorly considered policy which was designed to apply to a radically different industry.

5. State Law Recognizes Liability Limitations

As indicated, the Commission requires utilities to turn to the states for liability protections. See Order No. 888-A at 30,301. The Commission's policy is problematic, however, given the recent significant changes in the regulation of electric utilities. Restructuring of the electric utility industry, coupled with the industry changes encouraged by Order No. 888 and Order No. 2000, has resulted in the formation of stand-alone transmission companies which (a) do not file rate tariffs with state regulatory commissions because they are solely FERC-jurisdictional and (b) do not operate their transmission facilities, having surrendered such control to an independent system operator.

An examination of liability limitation provisions in public utility tariffs is helpful, however, to demonstrate the wide-spread and routine acceptance of such limitations by numerous state regulatory entities.[12] At the state level, "[c]ourts are virtually unanimous [in holding] that provisions limiting a public utility's liability are valid so long as they do not purport to grant immunity or limit liability for gross negligence." Garrison v. Pacific Northwest Bell, 608 P.2d 1206, 1211 (Ore. Ct. App. 1980). Even in cases of gross negligence, a few jurisdictions have not followed this

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[12] See, e.g., Danisco Ingredients USA, Inc. v. Kansas City Power & Lt. Co., 267 Kan. 760, 769 (1999) ("Generally, other jurisdictions have held that rules promulgated by public utilities which absolve them from liability for simple negligence in the delivery of their services are reasonable and will be upheld.") (citing Pilot Industries v. Southern Bell Tel. & Tel. Co., 495 F.Supp. 356, 361-62 (D.S.C. 1979); Olson v. Mountain States Tel. & Tel. Co., 119 Ariz. 321, 323, 580 P.2d 782 (Ct.App.1978); Professional Answering Serv. v. Chesapeake Tel., 565 A.2d 55, 63-65 (D.C.1989); Landrum v. Florida Power & Light Co., 505 So.2d 552, 554 (Fla.Dist.App.1987); Southern Bell Tel. Co. v. Invenchek, 130 Ga.App. 798, 800, 204 S.E.2d 457 (1974); In re Ill. Bell Switching, 161 Ill.2d 233, 244, 204 (1994); Computer Tool & Engineering v. NSP, 453 N.W.2d 569, 573 (Minn.App.1990); Warner v. Southwestern Bell Telephone Company, 428 S.W.2d 596, 601-02 (Mo.1968); Bulbman, Inc. v. Nevada Bell, 108 Nev. 105, 108-09, 825 P.2d 588 (1992); Lee v. Consolidated Edison, 98 Misc.2d 304, 306, 413 N.Y.S.2d 826 (1978); Garrison v. Pacific NW Bell, 45 Or.App. 523, 531-32, 608 P.2d 1206 (1980); Behrend v. Bell Tel. Co., 242 Pa.Super. 47, 74-75, 363 A.2d 1152 (1976), vacated 473 Pa. 320, 374 A.2d 536 (1977), reinstated 257 Pa.Super. 35, 390 A.2d 233 (1978); Southwestern Bell Telephone Co. v. Rucker, 537 S.W.2d 326, 331-32 (Tex.Civ.App.1976)).

majority rule and have allowed public utilities to enact rules which limit liability. See Professional Answering Serv. v. Chesapeake Tel., 565 A.2d 55, 63-65 (D.C.1989); In re Ill. Bell Switching, 161 Ill.2d 233, 244, (1994). In recognizing the validity of liability limiting provisions in general, a number of states have acknowledged that these limitations have a direct relationship to lower rates.[13]

6. Federal Law Recognizes Liability Limitations

Liability limitation provisions are routinely permitted to be included in public utility tariffs that are filed with a variety of federal regulatory entities. These federal tariffs, which have the effect of law, pre-empt state contract or tort claims. See American Tel. and Tel. Co. v. Central Off. Tel., Inc., 524 U.S. 214 (1998) (applying filed rate doctrine).

In some of the federal regulatory schemes, the remedies are specified in the statute. See, e.g., Boston & Maine RR v. Hooker, 233 U.S. 97, 109 (1914) (stating that regulation of interstate transportation is a matter of federal law to the exclusion of state-governed tort and contract law); see also 49 U.S.C. § 14706 (1994) (setting forth statutory rules of liability for motor carriers and freight forwarders);[14] and see Thyssen, Inc. v. S.S. Fortune Star, 777 F.2d 57, 64 (1985)

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[13] See Houston Lighting & Power Co. v. Auchan USA, Inc., 995 S.W.2d 668, 673 (1999) (citing Cole v. Pacific Tel. & Tel. Co., 112 Cal.App.2d 416, 246 P.2d 686, 688 (1952); Landrum v. Florida Power & Light Co., 505 So.2d 552, 554 (Fla.Dist.Ct.App.1987); Southern Bell Tel. & Tel. Co. v. Invenchek, Inc., 130 Ga.App. 798, 204 S.E.2d 457, 460 (1974); In re Illinois Bell Switching Station Litig., 161 Ill.2d 233, 204 Ill.Dec. 216, 641 N.E.2d 440, 446 (1994); Singer Co. v. Baltimore Gas & Elec. Co., 79 Md.App. 461, 558 A.2d 419, 427 (1989); Wilkinson v. New England Tel. & Tel. Co., 327 Mass. 132, 97 N.E.2d 413, 416 (1951); Computer Tool & Eng'g, Inc. v. Northern States Power Co., 453 N.W.2d 569, 573 (Minn.Ct.App.1990); Montana ex rel. Mountain States Tel. & Tel. Co. v. District Court, 160 Mont. 443, 503 P.2d 526, 528-29 (1972); Bulbman, Inc. v. Nevada Bell, 108 Nev. 105, 825 P.2d 588, 590-91 (1992); Coachlight Las Cruces, Ltd. v. Mountain Bell Tel. Co., 99 N.M. 796, 664 P.2d 994, 998-99 (App.1983); Lee v. Consolidated Edison Co., 98 Misc.2d 304, 413 N.Y.S.2d 826, 828 (1978); Behrend v. Bell Tel. Co., 242 Pa.Super. 47, 363 A.2d 1152, 1165 (1976), vacated and remanded, 473 Pa. 320, 374 A.2d 536 (1977), aff'd on remand, 257 Pa.Super. 35, 390 A.2d 233 (1978); Allen v. General Tel. Co., 20 Wash.App. 144, 578 P.2d 1333, 1337 (1978)).

[14] The Carmack Amendment of 1906 codified the general rule that if a motor carrier loses or damages the property it is carrying in interstate commerce, the carrier is liable for the actual loss or injury to the property. 49 USCA § 14706(a)(1). However, the carrier may establish rates under which the liability of the carrier for such property is limited to a value established by declared value or written

(describing statutory limitation on types of losses for which carrier could be held liable under United States Carriage of Goods by Sea Act of 1936; 46 U.S.C. § 1304).

In legislation where Congress has not granted a specific remedy, the rules applicable to liability – and limitations on liability – may be derived as a matter of federal common law. Courts rely on federal common law in four types of cases. That is, (a) where the rights of the United States are at issue, see Clearfield Trust Co. v. United States, 318 U.S. 363 (1943); (b) where the question presented concerns interstate boundaries or pollution, see Illinois v. City of Milwaukee, 406 U.S. 91 (1972); (c) where Congress has indicated its will that courts do so, see Textile Workers Union of America v. Lincoln Mills of Alabama, 353 U.S. 448 (1957); Ragsdale v. Airborne Freight Corp., 173 Ga.App. 48 (1985) (applying federal common law because the Federal Aviation Act "expressly preempts state regulation of air cargo carriers") (citing 49 U.S.C. § 1305(a));[15] and (d) "when a pervasive scheme of federal regulation indicates a Congressional objective that cannot be attained without the application of a uniform body of law." City of New Orleans v. United Gas Pipe Line Co., 390 F.Supp. 861 (1974) (citing Ivy Broadcasting Co. v. American Tel. & Tel., 391 F.2d 486 (1968)).

As discussed earlier in this memo, the Fifth Circuit addressed the issue of whether the Commission should have articulated a uniform federal standard of culpability when it determined that exculpation clauses applicable to curtailment-related contract claims would not limit liability stemming from actions or omissions that might have caused the curtailment. See United Gas, 824 F.2d at 426.[16] In its analysis, the court applied the test set forth in Pennzoil Co. v. FERC, 645 F.2d 360, 385 (5th Cir. 1981) which indicates when federal common law should apply in place of state law.

The court concluded that (a) the federal scheme of regulation under the NGA is not comprehensive and is limited in its displacement of state regulatory authority; (b) the federal interest extends only so far as necessary to protect the federal curtailment plan and exculpating a pipeline from its own negligence or

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agreement, so long as that value would be reasonable under the circumstances. 49 USCA § 14706(c).

[15] The court in Ragsdale also held that federal law prior to deregulation was applicable to post-deregulation questions because "the jurisdiction of the CAB and the extensive administrative procedures involving complaints about carrier rules were abolished, not the body of law applied to determine the reasonableness of those rules. Ragsdale, 173 Ga.App. at 49 (upholding limitation of liability which, in part, precluded recovery of consequential damages).

[16] See infra section 4(b).

willful misconduct "in all cases" would undermine incentives for prudent management of issues that might lead to curtailment; and (c) the need for uniformity of result extends only so far as needed to protect the federal interest. United Gas, 824 F.2d at 426. The court held that, given this analysis, it was reasonable for the Commission to limit the scope of the tariff's exculpation clauses to address only the failure of the pipeline to deliver contracted-for quantities of gas. Id.

The court in United Gas upheld the Commission's decision that those who curtailed deliveries in compliance with federal rules could not be held liable for breach of contract related to the curtailments. Id. (emphasis provided). Further, it ratified the Commission's decision to permit liability to flow from "mismanagement in causing the shortage of gas," id. at 427, because "if compliance with a filed curtailment scheme in all cases protects a pipeline from liability, a pipeline could contract to deliver more gas than it knows it is able, relying on the federal curtailment scheme to immunize it." Id. (emphasis added).[17]

Thus, each of the Commission's conclusions which the circuit court ratified were limited to the question of breach of contract related to a curtailment plan and the possibility that the curtailment itself might have been caused through negligence or willful misconduct. United Gas does not discuss tariff provisions which would limit liability in the event of "normal accidents" or simple negligence for the purpose of maintaining reasonable rates. Nonetheless, the Commission seizes on the United Gas holding and its progeny to argue that it should never permit tariffs to include provisions which limit liability.

In fact, United Gas established the precedent that exculpation clauses filed with the FERC in connection with issues related to a federal concern could preempt state law claims. In its opinion, the court affirmatively stated that a federal standard had been established by the Commission's rule. Id. at 428 ("Any standard of fault less than negligence is preempted by the federal standard."). In addition, the court molded that standard to include a required element of foreseeability because "the term 'negligence' is plastic in the hands of some courts . . . . [therefore] states are not free to attach consequences to curtailed deliveries that United with reasonable efforts could not have foreseen and avoided." Id.

Thus, in addition to ratifying the Commission's policy regarding exculpation of contract claims related to curtailments, United Gas unquestionably established two significant rules: (a) in issues related to the Natural Gas Act (and the Federal Power Act) federal common law will preempt state law when a federal

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[17] Of course, if a pipeline were to contract to deliver more gas than it knows it is able, it would be engaging in gross negligence or willful misconduct.

interest is involved and (b) displacement of liability will be honored up to and including those boundaries necessary to support the federal interest.

7. The Commission Should Re-Examine its Policy

In a nutshell, the Commission's policy should be revised. The current policy disregards the technical realities of "normal accidents" that will occur in the course of providing transmission service. Further, the policy ignores legitimate and sound federal legal precedents that recognize the validity of including liability limitations in the tariff of a regulated public utility.

The Commission's rote rejection of liability limitations between transmission provider and customer turns a blind-eye to the jurisdictional reality that state law liability limitations likely will not apply to, and thus will not safeguard, interstate transmission providers from the consequences of normal accidents. Further, the roots of the policy, although deep, are embedded in a fundamentally flawed legal analysis. In maintaining this policy, the Commission ignores the likelihood that failure of the transmission provider to obtain adequate insurance – or re-insurance after an outage – would be ruinous with far-reaching reliability consequences. It also places the cost of such insurance, assuming that it is available, squarely on the shoulders of the ratepayer.[18]

Order No. 2000 is replete with pricing incentives and other inducements to encourage transmission owners to form and to participate in a Regional Transmission Organizations. Incongruously, however, at the same time that the Commission dangles these financial "carrots" – thereby promoting financial underwriting for transmission system formation – it wields its "stick" of summarily rejecting liability limiting provisions which, for legitimate reasons, an embryonic RTO would seek to include in its pro forma tariff. See Avista Corp., 95 FERC ¶ 61,114 (2001), Slip Op. at 52. In the end, the Commission's policy is inconsistent, arbitrary, and not rationally based.

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[18] See, e.g., New York Indep. System Operator, Inc., et al., 90 FERC ¶ 61,012 at 61,034-35 (2000). (This assumes that an insurance company is willing to underwrite such a potentially speculative and limitless risk.) These insurance expenses, in turn, are recoverable costs of service. See New York Indep. System Operator, Inc., et al., 91 FERC ¶ 61,012 at 61,051 (2000) (agreeing that liability insurance is a cost of doing business and therefore recoverable).